



GOVERNOR'S REPORT ON THE

Workers Compensation Fund

JUNE 18, 2003

Governor Mike Leavitt
www.utah.gov



STATE OF UTAH

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June 18, 2003

The Honorable L. Alma Mansell
President of the Senate

The Honorable Martin R. Stephens
Speaker of the House

Members of the Utah Legislature

Dear President Mansell, Speaker Stephens, Honorable Legislators:

During the past several weeks, I have engaged in an in-depth review of the Workers Compensation Fund with the specific purpose of considering whether a change in WCF's status and mission is appropriate. I am pleased to present you with the product of these labors in the following pages and accompanying materials. This report represents the work of many expert hands and arduous analysis.

My report includes background and key policy issues, along with several details presented in question and answer format. My intent is to inform, not to make recommendations, although I reserve the right to offer recommendations in the future after you have a chance to study and discuss the issues. Included in my report are several attachments you will find referenced in the table of contents.

Simultaneously, I am conveying to you the reports of our outside experts: Deloitte & Touche, and Houlihan Lokey Howard & Zukin.

I intend to provide public access to all of this material by placing it on the state website at utah.gov

Because of the importance and complexity of these issues, I urge the Legislature and all interested parties to become engaged and study them carefully.

Sincerely,

Michael O. Leavitt
Governor

Table of Contents

Background and Policy Issues.....	1
Questions and Answers	
The Workers Compensation Fund.....	3
The Situation.....	4
Federal Tax Exemption.....	6
Alternative Structures.....	7
Value.....	9
Other Issues and Next Steps.....	10
Legal Issues Regarding the Possible Privatization of WCF.....	11
Summary of the Various Organizational Structures.....	14
Letter from the Workers Compensation Fund Regarding the Houlihan Report.....	16

Background and Policy Issues

Workers compensation developed across the nation in the early 20th century. Workers compensation laws in every state require employers to have insurance. When workplace accidents occur, the injured worker is paid benefits without having to go to court, according to a schedule of benefits authorized by the Legislature; but the employer is protected from litigation.

Many states set up state insurance funds to be the “insurer of last resort” to supply insurance to employers whose risk factors caused private insurers not to want to insure them. Utah’s Workers Compensation Fund (“WCF”) is the modern version of a state fund first instituted by the Legislature in 1917.

WCF was established by the state for a specific and well-defined purpose – to protect Utah workers by assuring that every Utah employer could obtain workers compensation insurance. Today WCF has captured more than 60% of Utah’s workers compensation insurance market. It has become a well-run insurance company that provides a valuable service to its customers and stability in Utah’s business environment. Over the years, it has accumulated substantial financial strength. WCF has the potential to do so at a much faster rate than an ordinary business because it is exempt from federal taxes.

During the last decade, two factors have begun to push WCF’s activities beyond the state of Utah’s boundaries. First, many of WCF’s most important customers have workers compensation needs in other states. If WCF is not able to provide coverage out-of-state to those customers, it could lose business. Second, as WCF developed large financial reserves, the board of directors increasingly felt the need to put those funds to good use.

Given the high level of skills the company has developed, the board of directors decided to use their financial capacity by writing workers compensation insurance in other states through a group of for-profit entities WCF has purchased or started. WCF sought and received authority to do so from the state Legislature. The operating presumption was that earnings they made by retaining business with multi-state insurance needs would benefit Utah customers in the form of lower rates. Of course, the inverse is also true: out-of-state losses could increase WCF’s Utah insurance rates.

These out-of-state activities are at the root of the policy questions currently faced by the state Legislature. As WCF’s out-of-state business increases, the likelihood of losing the federal tax exemption increases, because the for-profit business cannot be larger than the Utah non-profit business. The tax-exempt status is one of three differentiating points between WCF and every other insurance company operating in Utah. The second is that the state Legislature charters the company by statute, and the state appoints the board of directors. The third is that if profits are distributed, they go to policyholders in the form of cash dividends or reduced rates rather than to stockholders.

There are seven core policy issues.

1. What is the mission of WCF? Should the WCF be a tax-exempt, non-profit insurance company that exists exclusively to meet the needs of any Utah organization needing workers compensation insurance; or should WCF be an insurance company that pays federal taxes and has a mission that includes employers in other states?
2. If WCF remains the insurer of last resort in Utah, should it continue the existing practice of subsidizing undesirable risks by charging desirable risks more; or should those who cannot buy insurance in the general marketplace be charged the amount their own experience warrants?
3. If WCF is no longer tax exempt, what alternatives exist to serve the residual market?
4. If WCF's mission is to include insuring employers in other states, should the portion of the assets that the state owns remain at risk in WCF or be withdrawn for other public purposes?
5. If the decision is for the state to withdraw its assets from WCF, what is the amount?
6. If the decision is for the state to withdraw its assets from WCF, should WCF be made a mutual company, a stock company, or sold outright?
7. If the decision is for the state of Utah to withdraw its assets from WCF, how should we provide for proper accountability and governance to protect policyholders?

Q & A: The Workers Compensation Fund

1) What is workers compensation insurance?

- A) Workers compensation insurance pays the medical expenses, lost wages, and other benefits of injured workers, and protects insured employers against liability for work-related injuries. Coverage is required by state law for every employer.

2) What is the Workers Compensation Fund?

- A) The Workers Compensation Fund (WCF) is an insurance company created by the Legislature that functions as an independent entity of state government. WCF provides insurance products, claims administration, safety and special investigation services, and medical case management for Utah-based companies. More than 28,000 Utah employers are insured by the Fund. WCF serves the residual market as the insurer of last resort in the state of Utah.

3) What is an “independent entity”?

- A) “Independent entity” means an entity having a public purpose relating to state government or its citizens that is individually created by the state or is given the right to exist and conduct its affairs by the Legislature.

4) What are the “insurer of last resort” and the “residual market”?

- A) Because the state has legislatively required employers to have workers compensation insurance as a condition of doing business, there is an obligation to assure that there is a place to buy it. To satisfy that need, the state created WCF. As the insurer of last resort, WCF is required to insure any business, regardless of whether it can purchase insurance in the voluntary market. Simply stated, WCF cannot reject an applicant; it must take all employers that apply. The fact that WCF serves as the insurer of last resort for the residual market is a vital factor in its federal tax exemption. Other terms that are used in connection with the residual market or insurer of last resort include: “market of last resort,” “assigned risk pool,” “alternative market,” or “safety net.”

5) Why does WCF insure the state?

- A) Because state law requires that the state purchase workers compensation insurance only through WCF to give WCF an “anchor client.” As WCF’s largest customer, the state contributes to the health and stability of WCF so that WCF may serve Utah employers better.

Q & A: The Situation

6) What are the advantages of our current situation?

- A) Utah has a favorable workers compensation climate, having the second lowest rates in the United States. There are many things that contribute to that climate. For example, Utahns are not prone to excessive litigation; we have relatively low medical rates; and the Legislature has been conservative in managing workers compensation benefit levels. While other insurance companies write workers compensation business in Utah, WCF has a market share of over 60%. WCF is a well-run enterprise and in addition has the advantage of being tax exempt. As such, WCF has lower costs, which can be passed on to consumers. This advantage is especially beneficial for small employers and the residual market, which are essentially subsidized by the rest of the market.

7) If the current situation were so favorable, why would we want to change?

- A) Laws exist in 24 states that prohibit insurance companies that are controlled by other states from being licensed in their state. The rationale for this policy is that state-owned or state-controlled companies are typically tax exempt and unfairly compete against private carriers that are not.

WCF has a for-profit subsidiary called Advantage Workers Compensation Insurance Company. Through this for-profit subsidiary, WCF has believed that it could qualify to write business in the states with prohibitions against licensing companies controlled by other states. WCF started writing workers compensation for Utah customers who have exposures in other states and later expanded aggressively, writing workers compensation insurance for non-Utah employers in those states.

Fueled in large part by the protests of private insurance companies that operate without a tax-exempt status, some states, including Idaho and California have ruled that WCF is controlled by the state of Utah and, therefore, challenged WCF's ability to write business in their states. Prominent in their reasoning is the fact that the state appoints a majority of WCF's board of directors.

Idaho has imposed a November 1, 2003, deadline for WCF to make adequate changes so that it can continue to operate within its borders. On similar grounds, California has failed to approve a WCF subsidiary's application to do business in that state.

WCF believes that it faces the loss of some very profitable Utah-related business because WCF cannot serve their needs in other states. WCF also fears that irreparable damage could be done to its out-of-state operations, which it sees as having the benefit of geographic diversification.

8) Why not solve this problem by just having someone other than the state appoint the board of directors?

- A) This presents two problems. First, the criterion the IRS uses to grant an exemption from federal taxation requires the state to appoint a majority of the directors. Losing WCF's tax-exempt status could be a serious loss to Utah employers and would result in higher premiums. Second, the Legislature provided for the governor to appoint and the Senate to confirm directors, because it provides public accountability and protection for policyholders and the taxpayers of Utah.

9) Because action is necessary, what is the process?

- A) Ensuring a sound decision process is essential when dealing with an issue as complex and far-reaching as the potential privatization of the Workers Compensation Fund. Many groups and voices need to be heard, and we must allow enough time for everyone to fully digest the information.

What has been done?

- The consulting firm of Deloitte & Touche has completed a report outlining various options regarding the potential privatization of the Fund.
- Financial advisors from Houlihan Lokey Howard & Zukin were retained to complete a valuation analysis of WCF.
- Representatives from the National Council on Compensation Insurance (NCCI) have been brought in to discuss residual market alternatives.
- The governor organized a group of advisors that has provided and will continue to provide critical appraisal throughout the process of evaluating the future of WCF. The group includes representatives from the Attorney General's Office, State Auditor's Office, Utah State Legislature, Governor's Office, Department of Insurance, and business community.
- An open dialogue has been created with the WCF board of directors, as well as the major policyholders, other insurers, and various agents.

Q & A: Federal Tax Exemption

10) What are the criteria for WCF to maintain federal tax-exempt status?

- A) WCF is recognized as tax exempt under I.R.C. § 501(c)(27)(B). The Internal Revenue Service has ruled that WCF met all of the following requirements:
- The organization “is created by state law.”
 - The organization “is organized and operated under state law exclusively” to provide (i) workers compensation insurance that is either required by state law or for which state law provides substantial disincentives for failure to purchase such insurance, and (ii) “related coverage which is incidental to workers compensation insurance.”
 - The organization must provide workers compensation coverage to any employer in the state that seeks such coverage.
 - The state must “make a financial commitment with respect to [the] organization either by extending the full faith and credit of the state to the debt of the organization or by providing the initial operating capital of the organization.”
 - Assets of the organization must revert to the state upon dissolution or state law must not permit dissolution of the organization.
 - A majority of the board of directors or “oversight body” of the organization is appointed by the governor or another executive branch official of the state, by the state Legislature, or by both.

11) How important is the federal tax exemption?

- A) The tax exemption, all things being equal, allows WCF to accumulate capital faster and charge lower rates to consumers. The importance of the tax exemption is closely related to the level of earning. Conversely, when WCF is making money, the tax exemption becomes very important to the company's strategy. With a tax exemption, WCF can accept a higher underwriting loss (i.e., it is easier for policies to be priced lower relative to risk levels) and make up for it by not having investment earnings taxed. When investment earnings are taxed, WCF must try for lower underwriting losses (i.e., it is harder for policies to be priced lower relative to risk levels). The ability of WCF to accumulate capital and surplus is enhanced by the tax exemption.

12) Could the federal tax exemption be lost, and if so, how?

- A) The tax exemption can be lost. The tax exemption is closely related to the fact that WCF was formed by the state and maintains an ongoing relationship with the state; this includes WCF's designation as Utah's insurer of last resort. WCF would likely lose the tax exemption if ties with the state are eroded or WCF's for-profit business overshadows its Utah non-profit business.

13) What would be the impact of losing the federal tax exemption?

- A) The ability of WCF to accumulate capital and surplus would decrease and premium rates generally would ultimately increase.

Q & A: Alternative Structures

14) What are some alternative structures to ownership for WCF?

- A) There are several options detailed in the chart on page 14 of this report. The options include:
- Selling WCF.
 - Organizing it into a stock company.
 - Organizing it into a private mutual company that is not the insurer of last resort and does not retain the tax exemption.
 - Organizing it into a private mutual that remains the insurer of last resort and maintains the tax exemption.
 - Maintaining some variation of the status quo.
 - Making it more of a state agency.

15) If the stock scenario were selected for privatization, how would that process likely work?

- A) This would be determined by the Legislature, but one scenario could be as follows: WCF's assets would be transferred into a for-profit corporation. Shares would be issued to represent the value of WCF. The state would receive a portion of the stock in satisfaction of its interest as WCF's founder, sponsor, and policyholder. The balance of the stock could be distributed to policyholders on a proportional basis. The proportion of shares received would be determined by the policyholder's average premiums paid over the last five years, divided by the total average premiums paid by all policyholders over the same period. The stock would be listed on a stock exchange and the market would determine the value of shares as they were bought and sold in the open market. Shares could be sold at any time at the discretion of the policyholder.

16) How would the stock scenario impact policyholders financially?

- A) A conversion to a stock company would likely result in slightly higher premiums for policyholders. The degree of increase for policyholders would vary, depending on the size and risk factors of each policyholder. A greater percentage of premium increase is likely to fall on minimum premium accounts (i.e., policyholders currently paying premiums less than \$500/year). However, the increase in premiums would be offset by the value received in the form of a marketable security.

The following is an example of the potential financial impact for policyholders:

Assumptions:

Total value of WCF	\$420 million
State's interest (Founder's interest plus state's interest as policyholder)	\$124 million (29.4% of total value) ¹
Adjusted value after stock distribution to the state	\$296 million
Average annual total premiums for past five years	\$130 million
Total premiums for past five years	\$650 million

Estimated Financial Impact:

Size of Policyholder	Average Annual Premiums	Applied Ownership based on average premiums	Implied stock value after state's founder's distribution percentage
Large	\$1,000,000	.0077	\$2,300,000
Medium	\$200,000	.0015	\$457,000
Small	\$400	.000003	\$915

17) What are the alternatives to WCF being the insurer of last resort?

- A) There are a number of ways to handle the residual market
 - 1) Designate a carrier of last resort (CLR), who is required to accept anyone as a policyholder regardless of insurability. The carrier has latitude to determine pricing of the policy, but it is required to write all policies

¹ 29.4% is an assumed number based on the following: 4.4% is the state's interest as a policyholder; 25% is an arbitrary assumption adopted to illustrate the state's interest as founder and sponsor of WCF. Determination of the actual amount of the state's founder's interest depends on legal interpretation and is the subject of some discussion. See "Legal Issues Regarding Possible Privatization of WCF" on page 11 of this report.

requested by customers. This is the option currently in place with WCF designated as the carrier of last resort.

- 2) Develop an assigned risk pool administered by the National Council on Compensation Insurance (NCCI).
- 3) Develop an assigned risk pool administered by the state or someone other than NCCI.

The following is a description of the assigned risk mechanism:

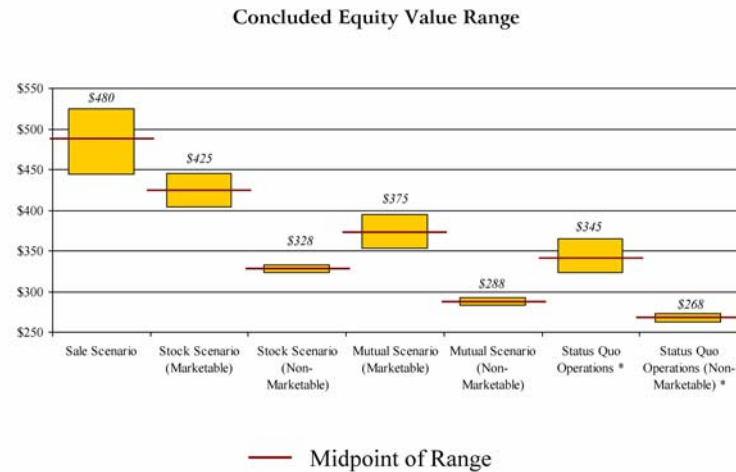
- After an employer is declined in the voluntary market (usually two to three declination letters required), the employer submits application to the administrator for coverage.
- The administrator processes the application, determines the premiums, and issues the policy.
- The issued policy is then sent to a servicing carrier. Usually one to three insurance companies licensed in the respective state are selected to be servicing carriers.
- The servicing carriers handle the claims administration for the policy for a fee of usually 25% to 45% of premium.
- Every workers compensation insurer in the state participates in the pool, regardless of who services each policy.
- Pool participants share in the losses of the pool in proportion to each insurer's share of the total workers compensation market in the state.
- The pool combines the experience of all the policies and then allocates any profit or loss to all participants in the pool proportionally.

Q & A: Value

18) What is the value of WCF?

- A) Financial advisors from Houlihan Lokey Howard & Zukin performed a valuation analysis of the Fund and produced the following Concluded Equity Value Range:

- ❖ The mid-point of our valuation conclusions range from \$268 million to \$480 million, with the Status Quo Operations (Non-Marketable) Scenario yielding the lowest valuation indication and the Sale Scenario yielding the highest.



*Assumes WCF retains tax-exempt status and is the insurer of last resort in Utah. Valuation does not depend on State ownership or mutualization status.

Source: Houlihan Lokey Howard & Zukin Financial Advisors, *Workers Compensation Fund Valuation Analysis as of May 30, 2003*, page. 4.

Q & A: Other Issues and Next Steps

19) What legal issues surround a change in WCF's status?

- A) The legal issues include:
- WCF's maintenance of the tax exemption.
 - The state must be compensated for its interest.
 - Constitutional concerns surrounding the state's role in creating a private corporation.
 - Issues regarding control of a privatized WCF.
 - Legal issues related to the Injury Fund.

Please see a detailed explanation of these issues on page 14 of this report.

20) How does WCF's for-profit business activities in other states benefit Utah policyholders?

- A) This report makes the basic assumption that WCF will lose its tax-exempt status if they continue to pursue out-of-state, for-profit, business. However, if WCF earns profits on out-of-state, for-profit business, that exceeds the value of the tax exemption, Utah policyholders will ultimately receive lower rates. Conversely, if WCF earns less money on out-of-state business than the value

of the tax exemption, or loses money, rates will be higher for Utah policyholders.

21) Are there alternatives to spreading risk besides seeking business in other states (geographic diversification)?

- A) Yes, by reinsurance. Reinsurance is insurance on insurance, that is, the transfer of all or a portion of a policy risk from one insurer to another. This is the principal risk-spreading mechanism WCF has utilized.

22) Is it reasonable to expect the voluntary market to subsidize the residual market and small employers?

- A) This is a question of availability vs. affordability and one of social policy. If we as a society have a social responsibility to ensure that all employers, large or small, can afford workers compensation insurance, then it is reasonable to expect subsidization. However, if our social responsibility is only to ensure that coverage is available, then subsidization is not a reasonable expectation. The latter assumes that each employer has the responsibility to afford coverage. Currently, the Labor Commissioner is aware of some employers being unable to afford insurance even though it is available.

23) Where do we go from here?

- A) The Legislature will now begin serious deliberations and take the time necessary to fully internalize the material and to make an informed decision. The Legislature may choose to speak with those involved in the issue. It is also assumed that the Legislature will hold some public hearings.

The governor makes no recommendation at this time but reserves the right to do so at a future date. He expresses a willingness to call a special legislative session in August 2003 if a firm proposal is on the table.

Legal Issues Regarding the Possible Privatization of WCF

(From an informal white paper submitted by the Office of the Attorney General)

I. Maintenance of Tax Exemption.

There is some question as to whether WCF can continue to qualify for tax-exempt status if it is privatized. The Attorney General's Office believes they most likely cannot. The Deloitte & Touche Report strongly recommends that the state obtain a federal income ruling on the issue. If maintenance of the tax exemption is important, that IRS ruling should be secured **before** any legislation to privatize WCF becomes final. (This is especially true if the proposal that was before the 2003 Legislature is adopted, because under that arrangement WCF's

responsibility to provide residual market coverage was contingent upon its ability to maintain its tax exemption.)

II. State Must Be Compensated For Its Interest.

The Utah Supreme Court has ruled that public property cannot be disposed of without receiving adequate consideration. Salt Lake County Commission v. Salt Lake County Attorney, 985 P.2d. 899, 909 (Utah 1999). The basis of that decision was Utah Const. Art. VI. Sec. 29. If WCF is privatized, the state's interest must be evaluated and fully compensated.

WCF obtained two legal opinions that conclude that the state has no financial interest in WCF. The opinions were written for WCF and often appear to be more in the form of advocacy for WCF's position than an objective review of the issues. The Attorney General's Office believes these opinions either misconstrue or do not address the best arguments in favor of the state having an interest in the WCF.

If WCF is sold on the open market with the state keeping the proceeds of sale as was done in Michigan, evaluation of the state's interest is not a problem, because the value would be determined by the market.

III. Constitutional Concerns.

Article XII, Section I of the Utah Constitution, which provides that corporations may not be created by special acts, appears to prohibit the Legislature from creating a private domestic stock or mutual insurance corporation as part of the privatization of WCF. If the Legislature desires to privatize WCF, therefore, it would either have to sell WCF or create some other mechanism that would not violate the Constitution.

IV. Issues Regarding Control of A Privatized WCF.

If WCF is privatized by some mechanism other than sale on the open market, consideration should be given to structuring it in a way that is responsive to policyholders and other interests. In the proposal that was before the 2003 Legislature, policyholders would have been allowed to elect the board of directors but would have been limited to voting only for candidates that were nominated by the existing board of directors. There was a provision that each policyholder get one vote no matter what the size of the policyholder. (The very big policyholders would have the same voting power as a very small policyholder.) Additionally, there was a provision that any policyholder that did not actively vote would automatically appoint the president of WCF as its proxy by payment of the premium. The president of WCF would, therefore, likely control selection of the board of directors under the proposed structure.

V. Legal Issues Related To The Injury Fund.

Since the beginning of a state workers compensation fund in Utah (1917), Utah statutes have (i) established an insurance fund, and (ii) provided for someone to administer the fund. The current statute refers to the insurance fund as the

“Injury Fund,” and creates an independent state entity called the Workers Compensation Fund to administer the Injury Fund. Current use of the word “Fund” in the name “Workers Compensation Fund” appears to be a misnomer. As currently constituted, WCF is not a fund, but rather a statutorily-created entity with statutory authority to administer the Injury Fund.

Since under existing law there is both a corporation and a fund, any legislation to privatize would have to make provisions for both.

Summary of the Various Organizational Structures

Matrix Legend:

Green items are considered positive from the perspective of Utah policyholders and potential Utah policyholders. These items assume that the risk of loss on out-of-state business is greater than the risk associated with no geographic diversification.

Red items are considered negative from the perspective of Utah policyholders and potential Utah policyholders. These items assume that the risk of loss on out-of-state business is greater than the risk associated with no geographic diversification.

Black items are considered positive or negative to policyholders, depending on whether the policyholder is part of the residual market or voluntary market.

Issue	Various Organizational Structures				
	Revert to State Agency	Maintain Status Quo	Mutual: Maintain Carrier of Last Resort & Tax Exempt Status	Mutual: Lose Carrier of Last Resort & Tax Exempt Status	Stock: Lose Carrier of Last Resort & Tax Exempt Status
Availability / Residual Market	<p>If pricing discipline is not maintained it could cause:</p> <ul style="list-style-type: none"> ➤ adverse selection ➤ over-subsidization ➤ market dislocation <p>If pricing discipline is maintained it could cause:</p> <ul style="list-style-type: none"> ➤ reasonable competition ➤ high assurance of available coverage 	<p>WCF less able to directly serve Utah employers with out-of-state employees</p> <p>Continued subsidization of residual market</p> <p>Competition restricted due to pricing advantage from tax exemption</p> <p>Current availability for residual market appears adequate</p>	<p>WCF better able to directly serve Utah employers with out-of-state employees</p> <p>Continued subsidization of residual market</p> <p>Competition restricted due to pricing advantage from tax exemption</p> <p>Current availability for residual market appears adequate</p>	<p>Changes in residual market alternative may cause inefficiencies</p> <p>Residual market would be more clearly identified</p> <p>NCCI, which has successfully implemented residual market services, could be used</p>	<p>Changes in residual market alternative may cause inefficiencies</p> <p>Residual market would be more clearly identified</p> <p>NCCI, which has successfully implemented residual market services, could be used</p>
Affordability	<p>Limited opportunity to increase affordability</p> <p>Inability of WCF to serve Utah employers with out-of-state employees</p> <p>Federal subsidization of rates due to tax exemption</p>	<p>Limited regional diversification</p> <p>Impact of market limitations on premiums is spread over years</p> <p>Federal subsidization due to tax exemption</p> <p>Limited competition to protect residual market</p>	<p>WCF expansion to other states may be unprofitable and subject Utah policyholders to out-of-state loss & increased premiums</p> <p>Federal subsidization due to tax exemption</p>	<p>Loss of federal subsidization of rates due to tax exemption</p> <p>Implementation of a new residual market mechanism could cause increased costs</p> <p>Voluntary market could benefit if subsidization is no longer utilized</p>	<p>Profit pressures on a stock company could cause premium levels to rise--most likely for voluntary market</p> <p>Value from stock would subsidize any increases in rates initially</p> <p>Voluntary market could benefit if subsidization is no longer utilized</p>

Issue	Various Organizational Structures				
	Revert to State Agency	Maintain Status Quo	Mutual: Maintain Carrier of Last Resort & Tax Exempt Status	Mutual: Lose Carrier of Last Resort & Tax Exempt Status	Stock: Lose Carrier of Last Resort & Tax Exempt Status
Tax Exemption	Exemption maintained	Exemption maintained	Exemption most likely lost	Exemption most likely lost	Exemption most likely lost
Value	<p>The value of WCF remains intact - no value is spun off to the state</p> <p>Value to policyholders is in the low rates and tax exemption</p>	<p>The value of WCF remains intact - no value is spun off to the state</p> <p>Value to policyholders is in the low rates and tax exemption</p>	<p>Opportunity for state to realize value</p> <p>Policyholders may have to concede some value to confirm ownership</p> <p>Potential for value accumulation going forward</p>	<p>Opportunity for state to realize value</p> <p>Policyholders may have to concede some value to confirm ownership</p> <p>Potential for value accumulation going forward</p>	<p>Opportunity for state to realize value</p> <p>Timing may not be right for stock issuance</p> <p>Market would determine value</p> <p>Potential for cash dividends</p> <p>Greater upside potential on investment</p>
Quality of Service	<p>State budgeting and oversight could negatively impact quality of service</p> <p>Limited or no ability to directly serve Utah employers with out-of-state employees</p> <p>Would focus on service with proven record</p>	<p>Limited or no ability to directly serve Utah employers with out-of-state employees</p> <p>Would focus on service with proven record</p>	<p>Balancing multi-state growth with service capacity could be a challenge</p> <p>Controlled growth and added experience would maintain and potentially enhance quality of service</p>	<p>Balancing multi-state growth with service capacity could be a challenge</p> <p>New residual market mechanism could disrupt quality--with sufficient lead time, disruption could be minimal</p>	<p>Balancing multi-state growth with service capacity could be a challenge</p> <p>New residual market mechanism could disrupt quality--with sufficient lead time disruption could be minimal</p>
Financial Strength	<p>Less access to capital markets</p> <p>Lose Guaranty Fund status</p> <p>State backing could assure viability</p> <p>Conservative approach subjects policyholders to less risk.</p> <p>Less possibility of geographic diversification</p>	<p>Less access to capital markets</p> <p>Maintain Guaranty Fund status</p> <p>Conservative approach subjects policyholders to less risk</p> <p>Less upside potential</p> <p>Less possibility of geographic diversification</p>	<p>Less access to capital markets</p> <p>Maintain Guaranty Fund status</p> <p>Payment to state satisfying ownership would reduce capital and surplus</p> <p>Operational strength may enhance viability even with concentration of risk</p>	<p>Less access to capital markets</p> <p>Maintain Guaranty Fund status</p> <p>Payment to state satisfying ownership would reduce capital and surplus</p> <p>Diversification could increase spread of risk</p>	<p>Maintain Guaranty Fund status</p> <p>Earnings pressure may encourage bad business decisions</p> <p>Greater access to capital markets</p>



June 17, 2003

Mr. Steven G. Fry, CPA
Chief Financial Examiner
Utah Insurance Department
3110 State Office Building
Salt Lake City, Utah 84111-6901

Dear Mr. Fry:

In follow-up to WCF's waiver of its right to comment on the Valuation Analysis prepared by Houlihan Lokey Howard & Zukin (the Houlihan Report), representatives of the Governor have asked WCF to provide a list of concerns that merit consideration by those using the Houlihan Report. WCF did not participate in the drafting of the actual Houlihan Report and did not receive a final copy of the Houlihan Report until yesterday. Accordingly, this list may not be all-inclusive.

- The Houlihan Report did not appropriately incorporate what WCF management believes are relatively low probabilities of the outcomes used in the stock and sale scenarios. We believe this resulted in an overstatement of the concluded values in those scenarios.
- We believe that the group of companies selected to develop industry multiples may not provide appropriate comparisons to WCF. The average assets, premiums and surplus of the companies used are seven to ten times larger than WCF. All the companies selected as comparables are multi-line carriers. We have not determined the impact, if any, the selection of the comparables had on the concluded values.

At a later time, we would appreciate the opportunity to discuss with the Department these and any other concerns that may arise from a more thorough review of the Houlihan Report.

We understand your need to release the Houlihan Report and would ask that this letter accompany it.

Sincerely,

A handwritten signature in dark ink, reading "Dennis V. Lloyd".

Dennis V. Lloyd
Senior Vice President
General Counsel

cc: **Leo Memmott**